The ACM Journal

Exodus

We've been renovating our house recently, and we finally got to the point where the construction mess and commotion was intolerable. Our friend generously offered to let us use her parent's house, as they live overseas and only use their local house a few months out of the year.

The new house is a bit of an inconvenience for us, as it is in a different school district. That means we're forever schlepping three kids back and forth to three different schools, but overall, we feel very fortunate to have a safe, clean place to stay.

While we're happy to have the house, I'm not sure the house is happy to have us. Indeed, the house has so far visited upon us the plagues of pestilence, flooding, lack of sleep, and attempted asphyxiation.

The second day after we moved in, we noticed a parade of ants on a thirty-foot pilgrimage from the family room to the kitchen. They marched in a line from under the baseboard, along a grout line in the tile floor, and up onto the kitchen counter. I assumed this was because our kids were leaving crumbs around, but the ants persisted even after a thorough cleaning.

I found some ant spray under the sink, and was able to get the nozzle up under the baseboard from whence they came. I arrogantly assumed that was the end of that, but it turned out I had only solved

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Portfolio Review

The first quarter of 2017 was a solid one for stock investors. Large-cap stocks rose over 6.0% in the quarter, as measured by the returns of the S&P 500 index. Historically, election years and the first year of a Presidential term are the strongest for stocks, and 2017 is shaping up to follow the historic pattern.

However, within the stock market, the dynamics have been very different over the past two quarters. The fourth quarter of last year was also strong for stock market returns, but in a very different way than the first quarter of this year. For example, value stocks and smaller company stocks performed strongly late last year, but lagged the overall market this year. International stocks also flip flopped, going from losses in the fourth quarter to the best performers in this year's first quarter.

Some of this is likely attributable to the Trump effect. When Donald Trump first took office, there was an enthusiasm in the market for what many perceived to be the ushering in of a new business-friendly era. Corporate and personal taxes would likely be reduced, and onerous regulations rolled back. Stocks soared in reaction, as many of these initiatives appeared supportive for corporate earnings growth.

This year, however, the realities of a fractious Washington, D.C. have set in. Certainly, policy differences between the political parties make it difficult to pass legislation, but even squabbles within the Republican party have derailed some of the Trump agenda. This has led many to question whether the promised reforms and initiatives will indeed come to pass. Stocks have generally held their gains, but riskier parts of the market, such as smaller company stocks and "value" stocks, have sold off somewhat in reaction.

International stocks are also often considered riskier, but actually outperformed significantly in the first quarter. This is because international stock markets offer lower valuations than the U.S. market, making investments overseas more attractive. The relative value that international stocks offer may make them stronger performers than domestic stocks for the next several years. An unusually strong dollar that is starting to give up some of its gains also gave a boost to international stocks in the first quarter, and offers further upside going forward.

Bonds posted a significant loss late last year as interest rates rose, but showed a modest gain in the early part of 2017. Again, government policies are likely to credit/blame for this. The Fed has continued to raise short-term interest rates, and long-term rates have generally followed, albeit in an erratic pattern. Also, Donald Trump's anticipated policies were expected to cause an increase in inflation, which is bad for bonds. Accordingly, bonds sold off a bit late last year, but have recovered somewhat this year as the odds of those polices being implemented are viewed more skeptically.

Alternative investments overall had a solid first quarter. However, there have been spots of strength and

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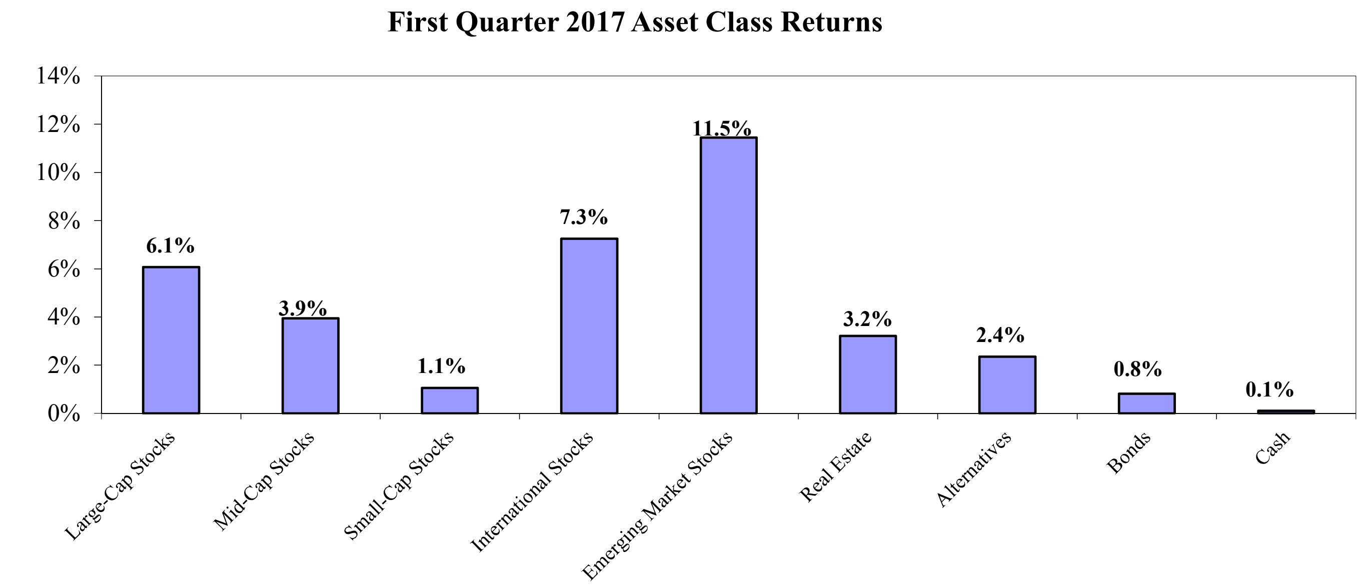

Large-cap, mid-cap, and small-cap stocks are represented by the S&P 500, 400, and 600 indcies. International and emerging market stocks are represented by MSCI indices. Real estate is the Dow Jones Real Estate index. Alternatives are represented by the HFRI Fund Weighted Composite Index. Bonds are the Barclays Aggregate Bond Index. Cash is the yield on the 30-day T-Bill.

Indexing Fares Well Over the Long Term

Standard & Poor's recently released its biannual study of mutual fund performance. S&P looks at the performance of actively-managed mutual funds versus appropriate stock market indices to see if the funds, as a group, added value for their investors.

Not surprisingly, actively-managed mutual funds fared poorly. The vast majority of them underperformed their benchmarks, showing that they have actually destroyed value for their clients. The table below shows the actual results. The odds of selecting a winning actively-managed mutual fund over the long-term are less than 8%.

% of Funds Underperforming

	5-Year	10-Year	15-Year
Large-Cap	88%	85%	92%
Mid-Cap	90%	96%	95%
Small-Cap	97%	96%	93%

Source: S&P Dow Jones Indices. Data as of 12/31/16.

It makes you wonder why anyone would pursue an active strategy if the odds of success are so low. We believe the answer lies with marketing and the "creative" way that the investment industry presents returns to investors. There are many regulations governing performance presentation, yet there is still ample room for the industry to put its best spin on things (or to put lipstick on the pig, as I prefer to say).

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Portfolio Review

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weakness lately in these funds. The less liquid funds we hold have performed quite well recently. The more liquid funds struggled last year, but are starting to perk up so far this year. Because our alternative investment portfolio is an eclectic mix of several diverse strategies, it is not surprising to have winners and losers at any point in time. We continue to believe they are an important diversification tool, particularly as stock and bond valuations remain at historically high levels (see related article on stock valuation).

Despite concerns over domestic policy and continued geopolitical worries overseas, the capital markets have produced solid returns so far this year. We still have three quarters to go to see if the full year holds to the historic pattern for solid gains. However, a low-cost, tax-managed, diversified portfolio provides your best chances for success in any market environment.

Stock Market Valuation

It is conference season, which means we've been on the road lately meeting with fund companies and hearing about their latest research.

One point that virtually everyone is making these days is that traditional asset classes (stocks and bonds) are richly valued, and likely won't generate the same level of returns in the future that we have experienced historically. The punchline at most of the conferences is that investors will need to seek out other asset classes, beyond stocks and bonds, in order to meet their return objectives. We agree with that to some degree, and we have indeed incorporated various "alternative" investments into our portfolios.

However, let's turn to the issue of valuation, particularly in the stock market. It is true that stocks trade at lofty levels by many metrics, but we're not sure we agree with a lot of the pronouncements in the media that we're on the eve of another major downturn. Certainly, that conclusion cannot be reached by stock market valuation alone.

As an example, many articles have been written recently about the CAPE ratio, its predictive powers, and what it is telling us today. The CAPE ratio was developed by Nobel Prize winner and Yale economics professor Robert Shiller. CAPE stands for cyclically-adjusted price/earnings ratio. It simply takes today's price and divides by the average earnings over the past ten years. Rather than measuring valuation at a particular point in time when earnings may be skewed one way or the other, the CAPE ratio tries to smooth out short-term influences.

There are a lot of important academic achievements in the world of finance, but most of them never make the headlines. The reason the CAPE ratio has become so famous is that Robert Shiller has used it to predict bubbles in the stock market previously. He accurately called the technology bubble and the real estate bubble in 2007. The fact that he is now a Nobel Laureate doesn't hurt his credibility either.

Today, the CAPE ratio has the third highest reading ever, and the data goes back to 1871. The previous higher readings were in 1929, just before the great depression, and in early 2000, just before the dot com bubble burst. The natural inclination then is to assume another damaging crash must be just around the corner.

The problem with that assumption is that valuation has been a poor market timing tool. That is, even when valuations have been quite high, the market does not necessarily respond. For example, I was working on Wall Street in 1996 when the stock market's price/earnings ratio was quite high. Many of the more seasoned analysts and strategists were recommending that investors sell out of the market. However, the stock market continued to rise for the next four years, earning returns of over 20% each year. The market did decline in 2000, but even at its lowest, it never went down to the levels in 1996. So, what seemed like a forecast based on prudent analysis actually turned out to be a money losing call.

While valuation has been somewhat indicative of future returns, the relationship is not as precise as one might like. Historically, when stock market valuations were at the low end, prospective ten-year returns have been fairly high. Conversely, high valuations historically have led to lower future returns. However, that hasn't always been the case, and even when high valuations do lead to lower long-term future returns, it can take years to play out (as in 1996).

Another problem with the thesis that a market crash is just around the corner is that not all valuation metrics are in agreement. Other valuation indicators, such as dividend yield or price-to-book value, show that the stock market is roughly in-line with its levels of the past 25 years.

Even Shiller's CAPE ratio is open to debate. Another academic, Wharton professor Jeremy Siegel wrote a paper a year or so ago that showed the CAPE ratio is likely over stated today versus its historic readings. This has to do with the way corporate earnings have been calculated, and how that calculation has changed over time. Jeremy Siegel's work shows that if a more consistent measure of earnings is used in the CAPE ratio, the reading is nowhere near as high as Robert Shiller suggests. I should note that even using the adjusted numbers, the CAPE is still higher than it has been historically, just not in the ridiculously overvalued range.

Where does this leave us? Unfortunately, none the wiser. No one has ever come up with a reliable method of timing the market. It may make sense to diversify into other asset classes, but getting out of stocks certainly is not a good idea for long-term investors. Interestingly, even Robert Shiller agrees. In a CNBC interview in February he said "My general thought is that I think it's quite reasonable to have an investment in U.S. stocks as part of a diversified portfolio. Just don't go overboard on it."

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the problem for a week or so. Then, the ants started coming from under the shoe moulding by the basement stairs. I went down to the basement and poked around in the ceiling, but never really found a proper nest. By spraying between two large floor joists, I was able to kill off a bunch of them. Again, I figured I had defeated the little buggers.

However, during a trip to the basement to deal with a loss of hot water, I noticed that the ants were now coming from out of the basement light switch. I took the entire switch apart and sprayed a liberal amount of what I'm sure is a carcinogenic compound all inside the switch cavity. Finally, the ants disappeared. That is, until just a couple days ago, when I noticed they were now coming from the wall by the front door. Despite many diligent attempts, to date we still have not been able to finally solve the ant problem.

During my apprenticeship as an exterminator, I also have become a part-time plumber. The kitchen faucet started leaking under the sink, which caused a small flood, and the innards of all the toilets have needed to be replaced. Yet, despite my plumbing experience, I was heretofore ignorant of how tankless hot water systems work. Thanks to our late season snow storm, I learned that snow clogs exhaust pipes, which leads to natural gas filling up your basement. When you discover this at 5:30 am, and there are two feet of snow in your driveway, it can make for quite a dramatic morning.

We also had a violent windstorm recently, which caused the power to go out for several days. Freezing temperatures inside the house notwithstanding, a protracted loss of power can cause other problems for a house as well. For example, smoke detector batteries can run low, causing all manner of chirping. This is especially true when there are six smoke detectors within a ten-foot radius. Whoever built this house was either terrified of fire, or somewhat inebriated when he installed the system.

It took us three days to silence all the chirping, despite changing all the batteries and resetting the system countless times. It seemed we finally had it figured out, and went to bed one recent night. At 11:30, the alarms all went off, and not just low-battery chirping. This was a full-on alarm with piercing sounds. That can be disorienting when you were previously sleeping soundly, but when you throw in a nervous wife and kids crying because they think the house is burning down, it can cause what can only be described as a cardiac event. After the second episode of the alarm going off, this time in the wee hours of the morning, I was close to ripping the whole system off the ceiling in a profanity-laced fit of rage. Fortunately, I was finally able to silence the alarm and the rest of the night was uneventful. The alarms are far less frequent now, but do still occasionally make our lives more exciting than we would like.

As of this writing we're still not able to move back into our own home. Life continues to be a bit hectic, and we've done extensive research on the suitability of anteaters as domestic pets. However, we're hoping the worst of the biblical plagues are behind us. And, despite the troubles, the new house has been better than living in drywall dust, without a kitchen, and sleeping on the living room floor.

Indexing Fares Well Over the Long Term

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The weak performance by active funds is not because active money managers are not trying or lack intelligence. In fact, they are often some of the brightest minds on the planet. However, the investment industry is so competitive that it is hard for any manager to get an edge over others. Add to that the huge hurdle that management fees and investment costs pose, and the odds of outperformance become impossibly small.

More money is moving to index funds these days, as evidence like the S&P study pile on to the already large canon of evidence that indexing provides superior returns. However, active management will not be going away any time soon. Just as large lobbying budgets can defeat common sense legislation, large marketing budgets can persuade plenty of investors that they should pay their money and spin the wheel. We prefer to stick with the evidence-based success of indexing.

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